

■ MERGERS AND ACQUISITIONS

Key findings from 2017 Survey of M&A Indemnification Deal Terms

A 2017 M&A Indemnification Survey uncovers key findings relating to representation, warranty and covenant survival periods, fundamental representations and warranties, exclusions from indemnifiable damages, materiality scrapes, indemnity basket and cap sizes, sandbagging clauses, and other trends.

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A M&A Indemnification Survey recently issued by our firm analyzed the key indemnification terms of 100 publicly filed acquisition agreements from June 1, 2016, to August 16, 2017, with transaction values ranging between \$100M and \$4.6B and a median transaction value of \$250M.

For the survey, a sampling was collected including asset purchase, stock purchase and merger agreements that were publicly filed with the U.S. Securities and Exchange Commission in which the target was a privately held business (including subsidiaries of public companies) and the buyer negotiated an indemnification remedy for breaches of representations, warranties and covenants that continued after the closing date.

While we note that our review and analysis are not technically scientific and do not include private transactions for which no agreement is publically available, we believe that the results generally reflect the climate of M&A transactions during the period.

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Key Findings

Representation, Warranty and Covenant Survival Periods

Approximately 77 percent of the deals surveyed had a general survival period of 12 to 18 months.

The median general survival period was 18 months, the shortest survival period was six months, and the longest survival period was 72 months.

In the majority of the deals surveyed, “Fundamental Representations” were defined as the seller’s representations and warranties relating to due authorization, no brokers, capitalization/share ownership and most notably, taxes. The seller’s representations and warranties relating to taxes were included in the definition of a “Fundamental Representation” in 71 percent of the deals surveyed and, on a stand-alone basis, as a carve out to the general survival period, in an additional 26 percent of the deals surveyed.

Although the scope of the definition is subject to negotiation in each transaction, the list of “Fundamental Representations” typically consists of the key representations and warranties of the seller that are needed to insure that the buyer obtains the benefit of its bargain. In an asset deal, title to the purchased assets is often included as a Fundamental Representation instead of the representation and warranty relating to capitalization/share ownership, which is commonly included in a stock deal. In addition to having a longer survival period, the Fundamental Representations are often carved out from the indemnification basket and indemnification cap.

In approximately 37 percent of the deals surveyed, no representations and warranties were carved out of the general survival period.

Approximately 60 percent of the deals surveyed did not specify a time limit as to when the buyer

would be entitled to bring a claim based on a breach of covenant by the seller. An additional 25 percent of the deals provided that such claims must be brought prior to the expiration of the applicable statute of limitations.

For those few deals in which the parties specified a time period, the median covenant survival time period was 36 months.

Exclusions from Indemnifiable Damages

Only 8 percent of the deals surveyed expressly included Diminution in Value in the definition of indemnifiable loss or damage.

Approximately 42 percent of the deals surveyed excluded Consequential Damages, which compensate the buyer for actual losses resulting from a breach of the seller's representations or warranties, from the definition of indemnifiable loss or damages. However, determining what qualifies as "consequential" damages versus direct or general damages remains difficult to apply in practice.¹

Approximately 46 percent of the deals surveyed were silent with regard to whether Consequential Damages are recoverable, and only 12 percent of the deals expressly included Consequential Damages in the definition of indemnifiable loss or damages. In many of the deals surveyed where there was an express waiver or exclusion of Consequential Damages, the buyer was permitted to recover Consequential Damages payable to a third party.

Approximately 26 percent of the deals surveyed excluded Loss of Revenue, Income or Profits from the definition of indemnifiable loss or damages. Approximately 63 percent of the deals were silent, and only 11 percent of the deals surveyed expressly included Loss of Revenue, Income or Profits in the definition of indemnifiable loss or damages.

When the buyer's ability to recover for Loss of Revenue, Income or Profits is excluded separately from indemnifiable damages (and not as an example of Consequential Damages), the buyer would be unable to recover, even when the loss was the direct result of the seller's breach. For example, if the seller made material misrepresentations relating to the

existence of an income-producing contract when, in fact, its customer had terminated the contract, the loss of revenue, income or profits reasonably might be considered direct damages that would not be excluded by a Consequential Damages waiver, but the damages would be excluded if this separate clause relating to Loss of Revenue, Income or Profits was included in the acquisition agreement.

In 62 percent of the deals surveyed, the damages recoverable by an indemnified party are calculated net of any insurance proceeds received by the indemnified party on account of such loss or damage. However, only 35 percent of those deals that provided that the damages recoverable would be calculated net of insurance imposed an affirmative obligation on the indemnified party to use commercially reasonable efforts (or a similar undertaking) to seek a recovery under the insurance policies covering the loss.

In 80 percent of the deals surveyed, the indemnification article of the acquisition agreement was the exclusive remedy for breaches of the acquisition agreement. Common carve outs to the exclusive remedies clause included fraud (54 percent); injunctive and provisional relief, including specific performance (18 percent); and intentional/willful breach of a representation or warranty (15 percent). For those deals in which the indemnification article of the acquisition agreement does not provide the exclusive remedy, the buyer would be entitled to recover all damages arising from the breach without regard to any baskets, caps or exclusions from indemnifiable damages or other seller-favorable limitation of liability provisions.

Indemnity Cap and Basket Size

Approximately 76 percent of deals surveyed had an indemnity cap, with a median cap size of 10 percent of the purchase price. Approximately 58 percent of transactions that included an indemnity cap had a cap of 10 percent or less.

The median basket size was 0.40 percent of the purchase price.

In a majority of the deals surveyed, the basket size did not exceed 0.50 percent of the purchase price,

which is substantially lower than the average basket of all types included in prior deal surveys conducted by SRS and the ABA for 2012–2015.²

Materiality Scrape

A “materiality scrape” refers to a clause in the acquisition agreement that reads out or “scrapes” the material adverse effect, materiality and similar qualifications in the applicable representations and warranties. Buyer’s counsel will argue the materiality scrape is necessary to avoid double materiality issues when the indemnification obligations of the seller relating to a breach of its representations and warranties are subject to a basket or deductible amount. The clause can provide that the materiality qualifications are disregarded for all indemnification purposes (that is, for determining breaches and calculating losses), or are disregarded only for the purpose of calculating losses.

Approximately 75 percent of the deals surveyed included a materiality scrape provision. Close to half (40 percent) of the deals surveyed, disregarding the material adverse effect, materiality and similar qualifications in the representations and warranties for the purposes of calculating the amount of losses and for determining whether a breach of a representation or warranty has occurred. This type of double materiality scrape is a buyer-friendly provision.

Sandbagging Clauses

“Sandbagging” clauses in acquisition agreements either seek to limit, or expressly authorize, the buyer’s ability to close over a known breach of a seller representation and warranty and bring a post-closing indemnification claim against the seller. The verb “sandbagging” dates back to the 1860s and refers to the practice of one person (presumably not a lawyer) bludgeoning another unsuspecting person with a small bag of sand.

Pro-sandbagging clauses (or knowledge savings clauses) expressly provide that the buyer’s indemnification or other remedy is not affected by any knowledge of the buyer. Anti-sandbagging clauses limit the seller’s liability for losses resulting from breaches of representations or warranties if the buyer had knowledge of the breach.

Approximately 75 percent of the deals surveyed were silent with regard to sandbagging. Approximately 25 percent of the deals surveyed included a pro-sandbagging clause. None of the deals surveyed included an anti-sandbagging clause.

In some jurisdictions (notably New York), there is a risk of a waiver if the buyer closes over a known breach of representation or warranty by the seller unless the buyer’s rights are preserved by virtue of a pro-sandbagging clause in the acquisition agreement or a similar clause preserving the rights of the buyer in an ancillary agreement.

Conclusion

Our survey provides a current assessment of what deal terms are market in a robust M&A environment.³ We expect the current deal-making environment will remain robust in the year ahead, with these indemnification clauses continuing to be a key component of any acquisition agreement for a private target company.

Notes

1. See *Biotronik A.G. vs. Conor MedSystems Ireland Ltd.* (NY Ct. of Appeals, March 27, 2014).
2. See 2016 SRS Acquiom M&A Deal Terms Study, analyzing private target deals between 2012 and the end of 2015; and 2014 ABA Private Target Mergers & Acquisitions Deal Points Study.
3. See *PitchBook’s* Quarterly M&A Reports for: 3Q 2017, 2Q 2017, 1Q 2017, and the 2016 Annual M&A Report.